C.D. Howe Institute
Commentary

www.cdhowe.org No. 181, April 2003 ISSN 8001-824

# Turbulence in the Skies:

## *Options for Making Canadian Airline Travel More Attractive*

Fred Lazar

***In this issue...***

*Should it matter to Canadian travelers and Canadians in general whether any Canadian airline survives to provide domestic service? The unequivocal answer is: You bet it matters!*

## *The Study in Brief*

This *Commentary* focuses on recommendations set out by the Canada Transportation Act Review Panel on permitting foreign entry into the domestic airline market and on the competitive landscape in passenger aviation services in Canada. The paper concentrates on the scope for new entry into the Canadian market, the likelihood that new entrants might, in fact, occur if the Canadian market is opened to foreign airlines and investors and the potential market impact if that did happen.

If the federal government succeeds in negotiating a more liberal agreement with the United States, the *Commentary* argues that there would be limited entry at best — there are a very small number of markets in Canada that provide entry opportunities — and the entry might end up displacing Canadian companies in terms of the routes they operate and the number of frequencies they provide on existing routes.

Even limited entry would weaken the financial performance of Westjet Airlines Ltd., though it might actually benefit Air Canada because it could use modified existing rights to maximize the benefits of its Toronto hub within a North American market.

While I fully support the recommendations of the Review Panel, I believe that the competitive consequences for the domestic Canadian market of a bilateral agreement with the United States are likely to be minimal. Perhaps it is time to recognize that the characteristics of the Canadian market limit the scope for competition and the number of domestic incumbents, regardless of the regulatory environment.

## *The Author of This Issue*

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$12.00; ISBN 0-88806-595-7
ISSN 0824-8001 (print); ISSN 1703-0765 (online)

Now that air Canada has entered into the bankruptcy protection process, what is the future direction for the airline industry in Canada? What, if anything, should the federal government do?

The starting point for this *Commentary* in addressing these questions is an examination of the recommendations set out by the Canada Transportation Act Review Panel in its report "Vision and Balance" (hereafter referred to as the Report) in June 2001. Transportation Minister David Collenette convened The Panel in 2000 to provide the decennial review of the *Canada Transportation Act*.

The principal recommendations of the Panel with regards to the airline industry were:[1]

- The government should negotiate a North American Common Aviation Area (NACAA) with the United States and Mexico to allow carriers from all three countries to compete freely throughout North America;
- In the event a NACAA cannot be negotiated, the government should negotiate with other countries reciprocal modified sixth-freedom rights and rights of establishment for foreign-owned carriers; and
- Foreign ownership limits should be raised to 49 percent.

This *Commentary* has the following objectives: To assess the merits of the the panel's recommendations for permitting foreign entry into the domestic market on the competitive landscape in passenger-aviation services in Canada, as well as the many developments in the commercial airline industry in Canada since its publication, including the move by Air Canada into court protection. As a result, I address the following issues:

- The scope for new entry into the Canadian market;
- The likelihood that new entry might in fact occur if the Canadian market is opened to foreign airlines and investors;
- The potential market impact of new entry, if it did occur.
- The role of government policy in the future.

The arguments I develop will support the view that even if the federal government succeeds in implementing the recommendations of the Review Panel, the competitive impact in the domestic market would be minimal Furthermore, I will argue that the less the federal government does, the better the chances for the industry to stabilize as the economic environment improves, and the more likely that Canadians will have competitive alternatives on the most densely traveled domestic routes.

Following a discussion of the policy issues involved in permitting foreign entry, I will move on to examine the barriers to entry into the airline industry. I then provide reviews of the post-deregulation experiences in the Canadian, U.S. and Australian airline industries in order to garner lessons for the issues to be

1 Report of the Canada Transportation Act Review Panel, Vision and Balance, Ottawa, June 2001, p. 123, 125.

addressed in the final section of the report. Afterwards, I give a brief overview of the federal government's National Airports policy. In the final section, I discuss the scope, likelihood and possible impact of entry if the recommendations proposed by the Review Panel are enacted.

In the Epilogue, I review the practicality of re-regulating this industry along the lines suggested by the Minister of Transportation.

I argue that even if the Government of Canada did succeed in negotiating more open, bilateral or multilateral agreements, there is no assurance that there would be any significant impact on the degree of competition in the Canadian market. Thus, even though the Review Panel is on the right track with its recommendations, we should not have high expectations for their possible impact on the Canadian market.[2] Indeed, all such restrictions should be removed and the airline industry globally should be unfettered from existing and archaic regulations, including foreign ownership restrictions.

## *The Background*

Deregulation of the domestic Canadian airline industry[3] has not produced the results forecast by its proponents, namely, a proliferation of competition through the entry of several new companies into the domestic market and a significant decline in the dominant airline's (Air Canada's) market share. Following Air Canada's takeover of Canadian Airlines International (CAI) in December 1999, Air

2 The ICAO will hold the Air Transport Conference in 2003 to discuss multilateral liberalization. Under the General Agreement on Trade in Services and the World Trade Organization, there is a once every five year review process of the Air Transport Annex to further liberalize international air transport services by progressively including more aspects on international air transport into the Annex.

3 International air service has not been fully deregulated. International markets are dominated by the Convention on International Aviation, the Chicago Convention of 1944. Airlines require the approval of their respective governments before they are allowed to operate international services between each other's countries. In the case of Canada, "[i]nternational air passenger services are governed by some 70 bilateral agreements between Canada and other countries. The agreements specify the rights of carriers on international routes, including cities to be served, aircraft to be used, and frequency of service to be provided." (Report, p. 119) However, these agreements and the Chicago Convention require that the carriers given rights under bilateral accords must be owned and controlled by citizens of their respective home countries. That is, under the current rules, a Canadian-based airline must be owned and controlled by Canadians in order to have a right to serve a foreign destination from Canada under a bilateral agreement. There are exceptions. Germany, in a number of recent instances, has negotiated a designation clause enabling it to designate German-owned-and-controlled carriers, but also carriers that are majority owned and effectively controlled by other European Union states or nationals of such states. The United Kingdom recently revised its model air service agreement so that airlines must have their principal place of business in the designating country and must have their air operators' certificates issued by that country. The bilateral agreements have become more liberal in the form of Open Skies agreements, allowing almost unlimited access between the two countries that are signatories to such agreements for carriers based in the two countries. For example, airlines in country A are free to fly to any destination in country B from any destination in country A. But they cannot pick up domestic passengers in country B and fly them between two cities in country B. Several of the Open Skies agreements, particularly those between the United States and other countries, allow for fifth- and sixth-freedom rights.

**A Glossary**

A *Traffic Right* is the right granted under a bilateral agreement for an airline to transport passengers over an authorized route or routes between two or more countries. A traffic right is associated with one or more of the nine freedoms of the air.

*First Freedom* is a right or privilege, in respect of scheduled international air services, granted by one state to an airline or airlines of another state or states to fly across its territory without landing.

*Second Freedom* is a right or privilege, in respect of scheduled international air services, granted by one state to an airline or airlines of another state or states to land in its territory for non-traffic purposes; for example, to refuel aircraft, to make unexpected repairs or to respond to an emergency.

*Third Freedom* is a right or privilege granted by one state to an airline or airlines of another state or states to put down in the territory of the first state traffic coming from the home state of the airline.

*Fourth Freedom* is a right or privilege granted by one state to an airline or airlines of another state or states to take on in the territory of the first state traffic destined for the home state of the airline. (Third- and fourth-freedom rights generally go together in bilateral agreements.)

*Fifth Freedom* is a right or privilege granted by one state to an airline or airlines of another state or states to put down and to take on traffic in the territory of the first state, coming from or destined to a third state.

*Sixth Freedom* is not technically a separate right and not currently negotiated between states. It results from the ability of an airline to combine third- and fourth-freedom rights under different bilateral air transport agreements such that an airline can offer a service between third countries by way of a connection in its home country. For example, Air Canada could potentially fly a traveler in Los Angeles to Paris via Toronto by combining rights under the Canada-United States and Canada-France agreements.

*Modified Sixth Freedom* is not technically a separate right and not currently negotiated between Canada and other countries. An airline in one state could have the ability to fly a traveler in the other state to another destination within that state via a connection in the airline's home country.

*Seventh Freedom* is a right or privilege granted by one state to an airline or airlines of another state to put down and to take on traffic in the territory of the first state coming from or destined to a third state, independent of the airline providing services (under third- and fourth-freedom rights) between the state and the home market of the airline. This differs from fifth-freedom rights because under this provision an airline from country A could operate between countries B and C without flying between country A and either B or C (the countries granting the right). Under fifth freedom, the airline from country A is given the right to extend its current services to country B beyond country B (the country granting the right), picking up travelers originating in B and heading for C.

*Eighth Freedom* is a right or privilege granted by one state to an airline or airlines of another state to put down and to take on traffic in the territory of the first state coming from one city in that state and destined to another city in that state as an extension of its third- and fourth-freedom rights. Under this right, also known as consecutive cabotage, Air France, for example, could be allowed to pick up passengers in Montreal (Toronto) destined for Toronto (Montreal) on its route Paris-Montreal-Toronto-Montreal-Paris under a Canada-France agreement.

*Ninth Freedom* is the right or privilege granted by one state to an airline or airlines of another state to put down and to take on domestic traffic in the territory of the first state between any two destinations in that first state without the need for any connection to the international network of the airline. This freedom, also known as stand-alone cabotage, would permit Continental Airlines, for example, to carry passengers between Vancouver and Calgary without operating any services between either of these Canadian cities and any one of the U.S. cities in its domestic network.

Canada's share of the domestic market exceeded 80 percent. Two years later, Air Canada's domestic market share still exceeded 80 percent. Only in the past 12 months, with the continued growth of Westjet Airlines Ltd. and the re-entry of Canjet and Jetsgo Corp., has Air Canada's share of the domestic market declined to where it now stands, at just above 65 percent. By comparison, Qantas Airlines currently has in excess of 80 percent of the domestic Australian market,[4] and American Airlines, the largest carrier in the U.S., controls just over 20 percent of the domestic U.S. market.[5]

Entry did take place in the Canadian market following the demise of CAI and Air Canada's domestic market share did erode at one point to between 65 percent and 70 percent. However, in 2001, the collapse of Roots Air, the takeovers of Canjet and Royal Air by Canada 3000, the subsequent failure of Canada 3000, the creation of Air Canada Tango — a no-frills, low-fare unit within Air Canada — and the economic consequences of September 11, 2001, for the airline industry worldwide — chilled the prospects for new entry into the domestic market and Air Canada's market share jumped to 80 percent by the end of 2001.

But hope springs eternal in this industry. Following the cessation of operations by Canada 3000, Skyservice, a partner in the Roots Air venture, announced plans to increase the number of planes in its fleet and expand its charter operations throughout Canada, possibly starting up a small number of scheduled domestic routes, as well. In February 2002, Robert Deluce announced his plans to create a new airline operating out of the Toronto City Centre Airport to serve a number of destinations in the United States, Ontario and Quebec. With the announcement of firm orders to acquire up to 25 Q400 turboprops from Bombardier, this new airline continues to move ahead towards a planned April 2004 launch date.

*If either or both Canjet and Jetsgo fail again and Westjet targets the trans-border market, Air Canada's share of the domestic market will increase.*

More recently, the founders of Canjet and Royal Air[6] also re-entered the domestic market. Westjet is expanding its fleet and route network across Canada. And Air Canada has introduced ZIP — another no-frills, low-fare division operating in Western Canada. Consequently, Air Canada's share of the domestic market has once more dropped to 70 percent.

With the exception of the expansion by Westjet, the jury is still out on whether Canjet and Jetsgo will survive, especially now that Air Canada is in bankruptcy proceedings. If either or both fail again and Westjet targets the trans-border market for much of its future growth, and Air Canada does emerge from bankruptcy protection with a significantly lower cost structure, Air Canada's share of the domestic market will rise again, by default. If this happens and the prospects are quite good, a second phase of deregulation of the domestic market might be necessary to introduce foreign competition into the Canadian market and once again erode Air Canada's market share. On the other hand, if Westjet takes advantage of the uncertainties facing Air Canada and passengers across the country as the national airline wends its way through its current difficulties to

4 Prior to the deregulation of the Australian market in 1990, Australian Airlines (now part of Qantas) had 55 percent of the domestic market.

5 In 1978, the six largest carriers in the United States had a combined 70 percent of the domestic market. Today, the six leading airlines have almost 80 percent of the domestic market in the United States.

6 The new airline is called Jetsgo.

accelerate its pace of expansion, Westjet could capture between 35 and 40 percent of the domestic market within the next 12-to-18 months. In that case, there would be little pressure on Ottawa to implement a second phase of deregulation.

The Review Panel considered three options by which the Canadian market could be opened further to foreign airlines and investors. The current foreign ownership limits could be relaxed, though not eliminated altogether. The *Canada Transportation Act* requires that holders of air carrier licenses be Canadian, controlled in fact by Canadians,[7] and that at least 75 percent of their voting interests be owned and controlled by Canadians. The Canadian rules could be changed to permit non-Canadians to hold as much as 49 percent of the voting equity in Canadian-licensed airlines. The Canadian-control requirement (necessary for the bilateral agreements) could be maintained by limiting the equity holdings of any one foreign entity or related group to 25 percent or less.

A second option involves granting foreign airlines modified sixth-freedom rights (see box), consecutive cabotage rights (eighth-freedom rights) and stand-alone cabotage rights (ninth-freedom rights). Modified sixth freedom would allow a U.S. carrier, for example, to carry Canadian passengers between two cities in Canada through a U.S. hub. With modified sixth-freedom rights, American Airlines could operate Calgary-Chicago-Toronto and sell Calgary-Toronto tickets to Canadian passengers.[8] Consecutive cabotage would enable U.S. carrier to operate a domestic route in Canada as an extension of one of its trans-border routes. For example, Northwest Airlines could extend its current Detroit-Toronto route to Ottawa and pick up Canadian passengers in Toronto who are traveling to Ottawa. Stand-alone cabotage would allow any foreign carrier to operate purely domestic routes in Canada without any connection to their domestic networks. As a result, a U.S. carrier, for example, could provide service between Winnipeg and Vancouver, even though it did not operate any trans-border route with either Winnipeg or Vancouver as the Canadian end-point.

The third option is a variant of granting stand-alone cabotage rights. Foreign airlines or investors could start up and own as much as 100 percent of an airline in Canada that operates only Canadian domestic routes.

The Review Panel reached the following conclusions:

- The government should negotiate a North American Common Aviation Area with the United States and Mexico;
- In the event a NACAA cannot be negotiated, the government should negotiate with other countries reciprocal modified sixth-freedom rights and rights of establishment for foreign-owned carriers;
- Foreign ownership limits should be raised to 49 percent.

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7 Economic equity held by non-Canadians can exceed 25 percent to a maximum of 33 percent. The U.S. rules restrict foreign ownership to a maximum of 25 percent of the voting interests and a maximum of 49 percent of the economic interest. In special circumstances, the Department of Transportation may permit non-U.S. citizens to hold up to 49 percent of the voting equity.

8 American Airlines already flies between Chicago and both Toronto and Calgary. American Airlines does have the right to sell Toronto-Tokyo, via Chicago or Dallas Fort Worth, to travelers originating in Canada.

The Review Panel opposed unilateral actions by the government to allow foreign entry.[9]

Thus far, the transport minister has shown no inclination to pursue any of the options proposed by the Review Panel. At this time, he appears to be like a deer caught in the headlights — not knowing which direction, if any, to take.

## *Policy Considerations*

There have been other proposals put forth to increase competition in the Canadian market, including re-regulation and unilateral actions by Canada to open up the domestic market to foreign airlines and investors. With Air Canada in bankruptcy protection, the unilateral option is becoming more popular.

Unilateral actions likely would eliminate the possibility of new entry by a Canadian company because they would increase the risks that such a company would face and thus deter investors from backing the venture. Unilateral actions at this time could also jeopardize Air Canada's effort to emerge from protection later this year. But should it matter to Canadian consumers and Canadians in general whether any Canadian airline survives to provide domestic service?

With regard to the re-regulation proposals put out as trial balloons in the spring of 2002 by Transport Minister Collenette, they would not likely produce competition. At best, they might increase the number of competitors, but at the expense of stifling competition and innovation. In effect, the transport minister has proposed a three-headed regulatory structure — the worst of all possibilities for re-regulating the industry. The Canada Transport Agency would be responsible for regulating prices. The Competition Bureau would be given new powers to regulate the conduct of Air Canada and some new agency would have to be created to allocate and monitor market shares in Canada. The transport minister appeared to realize the flaws in his re-regulation proposal since little has been heard of it since. However, in light of Air Canada's current position, Collenette might re-surface his ideas as a means of protecting Air Canada.

Any attempt to force the market to produce the desired outcome is likely to stifle competition and produce inferior results. Thus, I support the positions adopted by the Review Panel with respect to the aviation industry in Canada. And I am very concerned by Ottawa's zig-zags in policy. Collenette wants to leave a legacy, other than the one of presiding over the largest number of bankruptcies in the airline industry in Canada, and he may be prone to the temptation to intervene without any clear objectives or fundamental understanding of the competitive nature of the industry.

The panel was correct to reject unilateral actions by the Government of Canada to grant foreign carriers eighth-, ninth- or modified sixth-freedom rights, preferring bilateral or multilateral negotiations to further liberate the international and domestic aviation industry. Nevertheless, there is no assurance that any of the panel's proposed changes might occur.

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9 Debra Ward, the Transition Observer on Airline Restructuring, argued in favour of unilateral actions if there was little interest on the part of other countries in free trade agreements in aviation services.

The United States might not be receptive to such changes, although in the aftermath of the September 11, 2001, terrorist attacks and the continuing malaise in the industry, U.S. carriers might be willing to support bilateral negotiations in order to gain the support of the Administration for another round of mergers, especially as the Chapter 11 filings by U.S. Airways and United Airlines indicate that there is too much capacity and possibly too many competitors in the industry in the United States. The CEO of American Airlines has suggested that the time has come for the Canadian and U.S. governments to negotiate a truly open skies arrangement. A new round of consolidation in the industry, which probably is inevitable, might be more palatable to the U.S. Government if the current open skies agreements are further liberalized to provide some scope for foreign competition in the U.S. market.

On the subject of airfares, it is noteworthy that since the takeover of CAI by Air Canada, domestic airfares as charged by the airlines, excluding government taxes, airport improvement fees (AIFs) and Nav Canada costs, have declined, although some of the all-inclusive fares paid by travelers within Canada are rising. The introduction of AIFs by more airport authorities, increases in the AIFs and other charges set by the airport authorities and Nav Canada, the organization that manages air-traffic control operations at airports, and the federal government's introduction of the Airport Security Tax — which the government halved for domestic travel in the recent federal budget — have pushed up fares in Canada, particularly for domestic travel. In the airline industry in Canada, the large airport authorities and Nav Canada come closest to being pure monopolies and they have largely escaped the glare of the public.

*Nav Canada, which is self-financing and derives its revenue from user charges, has even more market power than the airport authorities.*

The Review Panel pointed out that a federal government review of the Canadian Airport Authorities (CAAs) concluded that the "market power of the CAAs was underestimated and checks and balances have not operated as expected."[10] With the exception of Thunder Bay, which stopped charging an AIF in November 2001, the fees range from $5-to-$15 for the National Airport System's airports,[11] with most charging $10. However, more airports are likely to follow the leads of Edmonton, Ottawa and Dorval and increase the fees to $15.[12] By and large, the AIFs charged by Canadian airports exceed the Passenger Facilities Charges (PFCs) of U.S. airports, which range between US$3.00 and US$4.50.

The eight largest airports across Canada — Calgary, Edmonton, Halifax, Montreal, Ottawa, Toronto, Vancouver and Winnipeg — collectively earned a net profit of $140 million in 2001, even though they are non-profit organizations. Their total revenue increased 9.7 percent in 2001 — by comparison, the total revenues of

10 Ibid, p. 152. The prices charged by the airport authorities are not subject to review, even though they are required to provide 60-days' notice of price increases and provide a justification for the increases.

11 These are the largest airports, by number of passengers, in Canada. They include Kelowna, Prince George, Vancouver, Victoria, Calgary, Edmonton, Regina, Saskatoon, Winnipeg, London, Ottawa, Sudbury, Thunder Bay, Toronto, Montreal Dorval, Mirabel, Québec City, Fredericton, Moncton, Halifax, Saint John, Charlottetown, Gander, St. John's, Yellowknife and Whitehorse.

12 Many of the airport authorities had to introduce these fees in order to issue bonds to finance their capital projects. Since the federal government continues to own the airports, the existing infrastructure cannot be used as collateral for the bonds. Other revenue streams have been used, as well, to support bond issues, so AIFs alone have not always been required.

Air Canada and Westjet increased by less than 5 percent and the total number of passengers at these airports did not change.

Vancouver Airport accumulated a surplus of $473 million by the end of 2001. Calgary and Montreal, two of the other three airports divested in the first round (1994/95), generated surpluses of $181 million and $170 million respectively by the end of 2001. The combined surplus of the eight airports increased 15 percent and 22 percent in 2001 and 2000 respectively, or by $308 million, since 1999. Of course, all of these airports will suffer declines in their revenues as Air Canada renegotiates contracts and lower fees with them. The airports may try to offset any reductions in fees paid by Air Canada by increasing their AIFs — in essence, acting as true monopolists. This would result in passengers on other airlines making up part of the cost savings by Air Canada.

Nav Canada, which is self-financing and derives its revenue from user charges, has sole responsibility for air navigation services within Canada and some adjacent oceanic air space. It has even more market power than the airport authorities. But users do have at least "60 days' notice of intention to revise a charge and if they believe that Nav Canada did not adhere to the charging principles, they can file an appeal with the Canadian Transportation Agency."[13]

*It is apparent, in light of Air Canada's financial performance, that a competitive advantage may not always translate into rising profit.*

The Review Panel acknowledged that "(e)stablishing an adequate control framework is complicated by the substantial market power airport authorities exercise in some areas. It is difficult to establish countervailing mechanisms to give those affected — including travelers — the ability to influence airport decisions."[14] Therefore, it is not surprising, though still disappointing, that the most the Review Panel could do was to put forth a rather innocuous recommendation (Recommendation 9.1, p. 164 in the Report) that would have little effect on curbing the market power of the airport authorities. The Panel had almost nothing to suggest regarding Nav Canada.

Yet, if there is any reason to propose increased regulation in the airline industry, the strongest case could be made to constrain the market power of the airport authorities by granting the Canadian Transportation Agency the mandate to review and approve the pricing of all of the major airport authorities before any new prices, including the Airport Improvement Fees, charged directly to passengers, can go into effect.

## Entry Barriers

The perceived or actual ability to replicate any one or more of the competitive advantages of incumbents — route network, frequent-flyer program, alliances, traffic feed, reputation, fleet size and composition, control over slots and gates,

13 Ibid, p. 155. Nav Canada must adhere to the following principles: "Charges cannot differentiate between domestic and international flights or between domestic and international carriers. There must be separate charges for en route and terminal services.... Charges must be consistent with Canada's international obligations. Charges must not raise greater revenues than required to meet Nav Canada's current and future financial requirements in relation to providing civil air navigation services." pp. 154, 155.

14 Ibid, p. 162.

yield management systems and other information technologies, financial engineering capabilities, such as hedging, leasing — or to create a new advantage are important determinants of the prospect of entry. However, there are numerous barriers that limit the ability of outsiders to match the capabilities of insiders and these barriers limit the degree of successful entry into this industry.

## Competitive Advantage

Competitive advantage is best defined as characteristics created by companies through the development and successful execution of strategies that enable them to outperform their competitors and consistently earn above average profits. A competitive advantage implies a degree of monopoly power. A company may have a competitive advantage based on being the lowest-cost producer in its industry. Or the advantage may be based on product differentiation; that is, a company may be supplying products with features that are both different from those offered by competitors and more desirable to customers, so that customers are willing to pay premium prices.

*The more frequencies offered, the shorter the waiting times and the lower the total costs of travel.*

In the airline industry, the Review Panel has identified the following sources of competitive advantage for Air Canada in the domestic market: "its extensive domestic network, its ability to offer frequent flights, its control over the main available frequent-flyer program, its well developed marketing and distribution system, and its favourable position at Pearson, Canada's major airport and the hub for domestic traffic."[17] It is apparent, in light of Air Canada's financial performance at the present time that a competitive advantage may not translate into superior profit at all times. Competitors also may possess a competitive advantage based on other factors — for example, Westjet has a competitive advantage stemming from its low cost structure — and the type of advantage the company has may be more valuable in the marketplace at a given point in time, particularly during a period of slackening economic growth. As well, competitive advantages may be overcome by competitors over time or a company may lose the basis for its competitive advantage through strategic miscalculations.

## Critical Barriers to Entry

The availability of talented management heads the list of entry barriers. Without a good management team, there is unlikely to be entry, and even if entry occurs, survival is highly unlikely.[18] Capital comes next on the list of entry barriers. This barrier includes access to capital and the cost of capital, both of which are

17. Ibid, p. 120.

18. Darryl Jenkins places weak management at the top of the list of reasons why entrants into the U.S. airline industry fail, followed by poor operational plans. He noted: "New entrants often hire executives with demonstrated records of failure. Over 97 percent of the carriers filing for Chapter 11 bankruptcy during the 1990s had senior executives who had been involved in a previous Chapter 11. Over 75 percent had senior executives who were involved in two bankruptcy filings and over 50 percent have had executives who were involved in at least three bankruptcy filings." Darryl Jenkins, "An examination of why new entrants fail," Aviation Institute, George Washington University, June 1998.

contingent on the reputation of the management team and whether the airline industry is in favour with investors, as well as future working-capital requirements and the time required to reach the break-even point.

The next critical entry barrier is infrastructure — reasonable access to airport facilities, such as slots, gates and terminal space, and the availability and competitiveness of secondary airports in major markets. Flight frequencies are very important for time-sensitive business travelers who have a high opportunity cost for their time. The more frequencies offered on a given route, the shorter are the waiting times and the lower the total costs of travel, including the opportunity costs of waiting and travel time and the out of pocket expenses — air fares, taxis, hotels and related expenses for these passengers.[17]

Flight frequencies affect capital and infrastructure requirements. To compete for the business traveler, an outsider must enter the market rapidly and on a large scale. However, this strategy is fraught with danger. Large scale and rapid entry increases capital and infrastructure needs. But unless a prospective entrant plans to compete for the business traveler, it might not be able to attract any capital for entry. Other business models, which focus entirely on leisure travelers, might be unattractive to investors.[18] On the other hand, because of the risks inherent in any entry strategy, regardless of the quality of management, the greater the capital requirements, the more difficult it might be to raise the capital.

Market size also has a major effect on the scale and speed of entry. How many markets offer scope for entry? That is, how many markets have the potential traffic necessary to support a large number of daily frequencies and generate profitable load factors? Related to this is how many markets can support more than one or two airlines?

Access to competitive forms of distribution (travel agents, online, in-house) is another entry barrier. The increasing popularity of distribution via the Internet is lessening the importance of this variable. So, too, is the improved neutrality of computer-reservation systems, although biases do persist.

Investors' anticipation of the competitive responses of the incumbents also will determine whether entry takes place. Incumbents have a number of strategies which they could select to attack or deter entry, among them: frequencies, capacity, pricing, creation of a new airline within the airline — for example, low-price, no-frills subsidiaries, such as the ones Air Canada is creating — restructuring of the route network, including more non-stops, more one-stop connections and aircraft types, as well as cost reductions.

Many of these barriers to entry are also barriers to survival of an entrant. Getting into the airline industry by itself is no assurance of financial success and

17 Darryl Jenkins has pointed out that when Southwest commits to a new city-pair market, it enters into that market with high frequency. Moreover, Southwest enters very few new markets each year. In contrast, most start-ups enter into many markets at one time with low frequencies in each. Most start-ups have failed because consumers want frequencies and most markets are dominated by the incumbents.

18 Despite their initial focus on the leisure market, Southwest and JetBlue have attracted large numbers of business travelers by providing high frequencies, low prices and reliable service on most of their routes.

survival. The U.S. airline industry has a graveyard filled with large numbers of unsuccessful entrants. There have been a number of failures in Canada as well.[19]

The entry options considered by the Review Panel would address several of the entry barriers. The possibility of entry into the domestic Canadian market by incumbent U.S. airlines for example,[20] should increase the pool of management talent. As well, these airlines should be able to access capital at competitive rates, have access to distribution channels and be able to match or improve the competitive advantages of incumbent Canadian airlines. On the other hand, entry by U.S. airlines would face the same infrastructure barriers as any Canadian entrant and there might be few markets in Canada that offer any potential for profitable entry.

Relaxing the current foreign ownership limits without changing the effective control requirements would address, at best, the capital barrier. This would do little to overcome the management barrier, infrastructure, market size and incumbent advantage barriers.

Even though these entry options could overcome some of the entry barriers, there is no reason to believe that any of them would accelerate the rate of entry or expand the number or scale of operations of entrants.

## The Canadian Airline Industry

*Westjet has succeeded because of strong management and a balance sheet superior to that of CAI, which was the dominant incumbant in Western Canada.*

Following the Canada Transport Commission Deregulation Hearings in 1984, the federal government announced a new airline policy.

### *The Deregulation Experience*

In order to better assess the possible ramifications of opening up the Canadian market to foreign competition along the lines recommended by the Review Committee, it is useful to step back and look at the deregulation experience in Canada.

The government's new airline policy set the stage for Ottawa to deregulate the industry in 1988 with the *National Transportation Act* (NTA). The Act legislated the deregulation of the civil aviation industry in southern Canada.[21] Between 1984 and 1988 when the new NTA came into force, the airline industry underwent a dramatic restructuring and consolidation. In 1984, there were four regional airlines, two national airlines and a large number of third-level carriers in Canada.

But competition was not the legacy of the government's initial efforts to deregulate the industry. CP Air acquired Eastern Provincial Airlines in 1984 and a

19 In addition to Canadian Airlines, there have been Wardair, Intair, Vistajet, Greyhound, Roots Air, Canjet 1, Royal and Canada 3000.

20 Through modified sixth-freedom rights, consecutive cabotage, stand-alone cabotage or foreign-owned pure domestic airlines.

21 Any Canadian-owned and controlled carrier that received an operating license was allowed to operate any type of aircraft between any city-pair in southern Canada, to offer as many frequencies as desired and to set its fares. Safety was and still is subject to regulation and international routes continued to be regulated by the bilateral treaties.

majority stake in Nordair in 1985. In 1986, Pacific Western Airlines (PWA) swallowed the much larger CP Air and the new airline was renamed Canadian Airlines International. Nordair, in turn, acquired Quebecair in 1987. CAI later fully acquired and integrated it. As a result, by the time the industry was deregulated, only one of the original regional airlines and one of the national airlines had survived.

Wardair, a non-schedule airline pre-1988, did enter into regularly scheduled service across Canada following the passage of the NTA. However, Wardair's participation in this segment of the industry was short-lived as both CAI and Air Canada increased frequencies on the routes that Wardair announced it would operate and both offered an increased number of discount fare seats on these routes. Within less than a year of its start-up of scheduled service, Wardair was taken over by CAI.

The next attempt at entry occurred in 1989. Inter-Canadien, a regional airline in which PWA had a 35-percent interest (acquired in 1987), left the PWA family in 1989 to form the independent carrier Intair to compete head-to-head with both Canadian and Air Canada in the Toronto-Ottawa-Montreal triangle. Intair lasted about one year.

It was not until the mid-1990s that further attempts were made at market entry. Vistajet tried to emulate the Intair model and met the same fate as Intair, failing in less than one year. Greyhound set up a hub-and-spoke network in 1996 with Winnipeg serving as the hub. This venture also failed.

*Canada 3000 issued new equity in 2000, but internal problems and stiff competition caused it to fail in 2001.*

In 1996, Westjet created a Western Canada, hub-and-spoke operation based in Calgary. Westjet not only survived, the company is expanding rapidly across Canada. It has succeeded where the other entrants failed because of strong management and a balance sheet superior to that of CAI, the dominant incumbent in Western Canada.

CAI's strength in the domestic market lay in Western Canada and the trans-Pacific markets, while Air Canada's strength was in Eastern Canada and the trans-border markets. CAI could not, or chose not, to engage in predatory actions to drive Westjet out of the market. The federal and Alberta governments did provide financial support to bail out CAI in 1991 and in 1996.[22] Air Canada, on the other hand, was much more aggressive in protecting its Eastern Canada strongholds and easily drove all entrants out of these markets.

Interestingly, at the same time that the original regional airlines were being transformed into a new national airline (CAI), both Air Canada and CAI created regional airline subsidiaries, which replicated the route structures of the original, but independent regional airlines. It was shortly after the Intair affair that Air Canada increased its equity stakes in its regional affiliates. The Intair experience provided two key lessons. Without control, a national carrier risks losing a regional partner, and a former partner can become a direct competitor.

22 CAI might have been better off over the long run if it had been forced to renegotiate with its debtholders and convert some of the debt into equity. The bailouts provided an easier way out for the company, but only in the short run. Shortly after acquiring CAI, Air Canada placed the company under bankruptcy protection and negotiated lower debt and more favourable payments terms with the holders of CAI's debt and leases.

Following the takeover of Canadian Airlines by Air Canada in December 1999,[23] possibly the greatest mistake made by Air Canada, several airlines announced plans to enter or expand into the scheduled-service market domestically. Westjet expanded its service in Western Canada and entered into the Eastern Canada market by selecting Hamilton Airport as its base of operations. The company has expanded its Hamilton operations and started service between Calgary and Edmonton and Toronto's Pearson Airport.

In July and August 2000, the company entered into agreements to purchase 26 Boeing 737-600 or -700 series aircraft, with options to purchase or lease an additional 68 aircraft. Westjet will use these aircraft to replace the existing fleet of Boeing 737-200s and to expand the company. As a result, Westjet may increase its fleet by up to 72 aircraft over the next eight years.

Royal Air transferred some aircraft from its cargo and charter operations to expand its scheduled service operations in Eastern Canada and across the country. Royal structured its domestic scheduled service as a hub-and-spoke network, with Toronto serving as the hub. The company started its scheduled domestic services, targeted at business travelers, in 1999. In September 2000, the company doubled its domestic-flight schedule, increased flight frequencies and started new city-pair routes. But rapid growth, a weakening economy and increased competition in the domestic market in Eastern Canada led the company to accept an offer to be acquired by Canada 3000 in January 2001.

*The lessons from deregulation in Canada are that small markets offer few opportunities for entry.*

Skyservice, a charter carrier, partnered with Roots, a clothing retail company, to start a scheduled airline, catering to business travelers. Roots Air commenced operations at the end of March 2001, serving Toronto-Vancouver and Toronto-Calgary. It ceased operations in 39 days.

The IMP Group started a new airline — Canjet — to provide low-fare service in Eastern Canada, with Winnipeg as the western terminus for the route network. A poor business model produced losses and Canjet, too, agreed to be acquired by Canada 3000 in March 2001.

Canada 3000 issued new equity in 2000 to finance the acquisition of additional aircraft and its expansion into scheduled-service operations domestically and internationally. The combination of rapid growth, integration problems with Canjet and Royal Air and aggressive competition from Air Canada, in particular Air Canada Tango, while demand was dropping sharply, led to the failure of Canada 3000 in November 2001.

However, both Canjet and Jetsgo, the newest incarnation of Royal Air, have re-entered the domestic market — Canjet focusing on Eastern Canada and Jetsgo slowly expanding across Canada and into the United States, with service to Manhattan-area Newark Airport.

In the international arena, Canada entered into an Open Skies Treaty with the United States in 1995. It became fully operational, allowing U.S. carriers access to

23 Tae Oum demonstrated that low costs do not translate into financial success in the airline industry. CAI had a much lower cost structure than Air Canada throughout the 1990s. However, CAI was much less successful than Air Canada in controlling its yields and it lost money in most years during the 1990s because its low yields more than offset its low cost advantage. See Tae Oum and Chunyan Yu, "Assessment of Recent Performance of Canadian carriers," Study prepared for the Canada Transportation Act Review Panel, February 13, 2001, draft.

Toronto by 1998. Under this agreement, all Canadian and U.S. carriers are authorized to operate on any and all trans-border routes without restrictions on equipment and frequencies. The head start given Canadian carriers and the foresight of Air Canada's management has enabled Air Canada to dominate the trans-border market.

On December 21, 1999, the transport minister introduced a new competitive framework for Canada's international air services and bilateral relations (excluding the United States) that included the ability for any interested Canadian carrier to provide scheduled service to all foreign markets exceeding 300,000 scheduled one-way passenger trips per year,[24] subject to the availability of bilateral air rights. This was done to encourage competition in large international markets following Air Canada's acquisition of Canadian Airlines. Smaller markets, those with fewer than 300,000 passengers per year, continued to be governed by the policy introduced in December 1994 until May 2002, when the Minister of Transportation amended this policy to open up the smaller markets, as well, to more competition.

The latest and probably the most dramatic development since the process of deregulation started almost 20 years ago is the fall of Air Canada. Court protection will give the company the time and opportunity to restructure its costs so that it might be competitive, not only with its domestic competitors, but also with the major U.S. carriers that are also restructuring and lowering their cost structures. However, the process under bankruptcy protection is not entirely predictable. Even though it would seem like a reasonable bet that Air Canada will exit as a lower-cost and possibly smaller airline, most likely with its existing senior management intact, there could be some surprises during the next several months.

*Despite the initial euphoria that greeted the entry of airlines such as People Express, the U.S. industry is increasingly concentrated.*

## Lessons from Deregulation

Overall, the lessons from the Canadian experience with deregulation appear to be that small markets offer few opportunities for entry and the opportunities that exist generally involve core markets for the incumbents. It is not surprising, therefore, that even prior to the failure of Canada 3000, Air Canada and its regional airline subsidiary were the sole operators in 120 city-pair markets in Canada. Further lessons from the Canadian experience are that the dominant carriers will protect their core markets and fight off entrants and will likely succeed because of the competitive advantages they have created. Of course, there have been a few exceptions. But wherever an incumbent has fallen by the wayside in Canada, poor management has been the critical factor.[25] Finally, the federal government's efforts to prop up and bail out Canadian airlines, for purely political reasons, have failed and have contributed to dragging down Air Canada.

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24 These markets currently include France, Germany, Hong Kong, Japan, Mexico, Taiwan and Britain.

25 Canjet, Roots Air and Canada 3000 all complained that Air Canada was abusing its dominant position and was trying to harm them. Ken Rowe, the CEO of Canjet, told the Competition Tribunal: "Air Canada's strategic conduct has already largely, if not entirely, destroyed Canjet's launch momentum." Canada 3000 told the House of Commons Standing Committee on Transport in May 2000 that Air Canada had cancelled a contract to provide ground services at some airports on short notice and without any offer to renegotiate the terms. Russell Payson, the CEO of Roots...

## The U.S. and Australian Experiences

*Deregulation in the United States.* Despite the initial euphoria that accompanied the entry of airlines such as People Express, the U.S. industry has become increasingly concentrated,[26] with only a handful of national airlines surviving, and most are in financial distress as a result of the combination of the slowdown in demand for air transportation services pre-September 11, 2001, and the sharp drop-off in air travel in the months following the terrorist attacks.

Four of the top eight national airlines in 1978 in the United States have ceased operating and one (United Airlines — the second largest airline in the world) is currently in Chapter 11 bankruptcy proceedings, and another (American Airlines — the world's largest airline) barely avoided Chapter 11 bankruptcy at this time. Only one of the original nine local service carriers (U.S. Airways) is still in business as an independent entity, though its future is uncertain, even though it has just emerged from Chapter 11.

Moreover, very few of the many airlines to which deregulation gave birth have survived.[27]

Still, there is sustained activity with the de novo entry by JetBlue and expansion by Southwest, AirTran and Frontier. Perhaps there is an upper limit to the aggregate market shares of low-cost airlines in the United States and elsewhere. But the market share may be sufficient to provide competitive pressures on fares in many domestic markets.

*In Australia, the initial effort at deregulation resulted in a couple of domestic entry attempts that failed.*

Just as entry is a characteristic of the U.S. market, so too is consolidation. ValuJet merged with AirTran in 1997. American Airlines acquired Reno Air and AMR Eagle bought out Business Express in 1998. Delta Airlines acquired Atlantic Southeast and Comair in 1999. American acquired TWA in 2001. Delta entered code-sharing agreements with Northwest and Continental, which have just been approved by the Department of Transportation, and the Department of Justice might approve a future merger proposal for U.S. Airways.

Consolidation is spurred by the desire to continually increase the scope and scale of the route networks. With the exception of Southwest Airlines, the major

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**Note 25 - continued**

...Air, accused Air Canada in February 2001 of using questionable tactics to try to undermine the company. (See Tom Ross and William Stanbury, "Policy Proposals for Enhancing Competition in Canadian Airline Markets," study prepared for the Canada Transportation Act Review Panel, March 11, 2001 draft, p. 2-16 and 2-17.) But Jenkins has concluded that according to the new entrant airlines that have filed for Chapter 11 bankruptcy protection, predatory practices by the major airlines were not a factor in their failure. The following reasons were cited most frequently in the bankruptcy filings of new entrants that failed: operational plans, excessive debt, escalating costs, inadequate traffic and economic downturns. (Darryl Jenkins, "An examination of why new entrants fail," Aviation Institute, George Washington University, June 1998.)

26 Alfred Kahn, one of the architects of deregulation in the United States has stated: "The natural structure of most airline markets, I observed, was monopolistic or oligopolistic — a market structure simply not conducive to bitter-end price competition. While counting on the relative ease of entry into airline markets to limit the exploitation of monopoly power, I repeatedly expressed skepticism about its adequacy." Alfred Kahn, "Airline Deregulation — A Mixed Bag, But a Clear Success Nevertheless," *Transportation Law Journal*, 1988 (V. 16, No. 2), p. 231, 232.

27 Darryl Jenkins, the director of the Aviation Institute at George Washington University, lists 129 airlines that failed between 1978 and 1997.

U.S. carriers have concentrated on building up the feed-through and the size and number of their hubs.[28] This has been an important component of their strategic responses to competition and of their focus on the business traveler. Fortress hubs reduce the competitive impact of entry and provide a basis for resorting to capacity, flight frequency, scheduling, frequent-flyer programs, travel-agent commission overrides and alliances for attacking new competitors.

The prevailing wisdom among economists in the late 1970s and early 1980s was that since there were no economies of scale in the airline industry, the sector was contestable. The supporters of deregulation defined airline markets improperly — citing each city-pair as a distinct and separate market — and ignored the importance of integrated route networks and network externalities,[29] especially the developing hub-and-spoke networks, and overlooked the importance of the S-curve phenomenon in this industry.[30] The contestability model did not apply to this industry.

*Deregulation in Australia.* In October 1990, the Government of Australia deregulated the domestic market. The two domestic incumbents, Australian Airlines and Ansett Airlines,[31] were given the freedom to determine capacity, fare levels and route structures. New airlines could enter into the domestic interstate market and deregulated intrastate markets[32] as long as they qualified and received airworthiness certificates and had access to terminal space and gates. Foreign ownership restrictions were still in place at that time and Qantas was restricted from entering the domestic market beyond its current level of operations.

*Qantas responded to the entry of Impulse and Virgin Blue by adopting the classic responses.*

This initial effort at deregulation resulted in a couple of domestic entry attempts that failed. Fast-forward to the end of the 1990s and several major changes had taken place in the Australian airline industry. Qantas was privatized in 1993 and acquired Australian Airlines in 1994, in effect creating the Australian equivalent of Air Canada. The *Qantas Sales Act* (1992) imposed a 49-percent foreign share limit for Qantas.[33]

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28 Even JetBlue has created a second hub — Long Beach Airport — to complement its east coast hub at JFK Airport.

29 See Fred Lazar, *Deregulation of the Canadian Airline Industry: A Charade*. Key Porter Books, 1984.

30 As an airline's percentage of the total available capacity on a particular city-pair increases, its share of the market increases more rapidly, hence it achieves higher load factors than its competitors, until the airline becomes the dominant carrier on that route. Douglas and Miler explained the S-curve as follows: "given the lack of information on all schedules, customers tend to call the airline with the greatest number of flights. Thus, the carrier with a larger share of total capacity receives a greater than proportional amount of traffic; conversely, the carrier with a small share of total capacity receives an even smaller share of total traffic." (C. Douglas and J. Miller, *Economic Regulation of Domestic Air Transport*. Brookings, 1974, p. 48) In the era of hub-and-spoke networks, the airline offering the greatest number of flights and destinations into and out of a particular city (the hub city) attracts a disproportionate share of the traffic. Increased frequencies reduce wait times and total travel costs.

31 Australian Airlines was owned by the federal government, as was Qantas. Qantas was not allowed to operate domestically other than by providing services between two cities in the country as part of an international route, such as Melbourne-Perth-Singapore. Ansett was owned in equal parts by Newscorp and TNT Transport, both private companies.

32 Every state other than New South Wales and Victoria had deregulated its markets.

33 British Airways owned 25 percent of Qantas.

The Australian Government introduced multiple designations in 1992, thus taking away Qantas's rights to be the sole international operator from Australia. To promote competition, the national government introduced legislation, which required the allocation of air rights to be biased against Qantas and in favour of new operators. As a result, Ansett gained its first international route authorities and was designated as Australia's second carrier for service on international routes.

In June 1999, the Government of Australia changed the Foreign Investment Review Board Sectoral Guidelines to allow foreign-owned airlines to operate domestic-only air services. Afterwards, Air New Zealand acquired 100 percent of Ansett Holdings in August 2000 after buying out News Corporation's 50-percent stake. In order to satisfy the new Guidelines, Ansett International, the operator on international routes out of Australia was spun off as a separate company, owned 49 percent by Ansett Holdings and 51 percent by Australian domestic institutions. But Air New Zealand had effective control over Ansett International. Ansett Domestic, which flew only within Australia, was 100 percent owned by Ansett Holdings and thus Air New Zealand. In August 2000, Singapore Airlines acquired a 25-percent stake in Air New Zealand after being thwarted in its attempts to acquire direct control of Ansett Airlines.[34]

*When Ottawa implemented a National Airports Policy, it shifted the government's role from owner and operator to landlord and regulator.*

The change in the Guidelines also opened the doors for Richard Branson to enter the domestic Australian market, which he did when he created Virgin Blue.[35]

Both Impulse Airlines, the sole domestic entrant, and Virgin Blue announced their plans in the second quarter of 2000 to enter into the domestic market. Several other companies did put forward plans to enter into the domestic market at around the same time that Richard Branson and Impulse Airlines made their announcements. None of these other airlines (Spirit, Aussie, Skymark) has come close to start up.

Qantas responded to the entry of Impulse and Virgin Blue by adopting the classic strategic responses — increasing capacity and flight frequencies and matching fares through the use of selective discount fares. But the significant increase in capacity and frequencies by Qantas might have been directed more at Ansett than the two entrants. Qantas viewed Singapore Airlines, through its interest in Air New Zealand and Air New Zealand's ownership of Ansett's domestic operations, as a greater long-term threat than either Impulse or Virgin Blue.

With aggressive competition from Qantas and a weakening economy, it is not surprising that Impulse agreed to be acquired by Qantas in April 2001. It is somewhat surprising, however, that Ansett failed. Once again, weak management

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34 Singapore Airlines acquired a 49-percent stake in Virgin Atlantic in December 1999. Consequently, the Brierley Group, which sold the 25-percent stake in Air New Zealand to Singapore, included the following poison pill in its agreement with Singapore Airlines: "[S]o long as Brierley holds not less than 5 percent of the issued shares of Air New Zealand, Singapore Airlines will not join Sir Richard Branson or any corporation associated with him in setting up an Australian domestic airline for five years or for as long as Singapore Airlines has board representation on Air New Zealand, whichever is earlier."

35 At the present time, Richard Branson owns 50 percent of Virgin Blue, having sold the other 50 percent to Patrick Corporation, an Australian shipping company, and is preparing an IPO for the airline. It is not part of Virgin Atlantic or Virgin Express, though there is a code sharing agreement between Virgin Blue and Virgin Atlantic.

is most likely the cause of the failure of this carrier. In the case of Quantas it is worth noting that the airline was able to quickly reject the government's request that it acquire Ansett and save thousands of jobs because the company did not have any concerns that political expedience would drive the government into bailing out Ansett. With Ansett out of the way, Qantas recently re-acquired a 20-percent stake in Air New Zealand. Deregulation in Australia has once more failed to produce a third domestic competitor.

## Lessons for Canada

There are several interesting lessons. There did appear to be room for two national airlines in Australia. But through poor management and neglect by the parent company, Ansett, which had about 35 percent of the domestic market, did fail. Were it not for poor management, CAI might have survived and might not have needed any form of government financial help. As well, as a result of a combination of the September 11 attacks, rapid growth through acquisitions and poor execution of the strategy to become predominantly a scheduled carrier, Canada 3000 failed. Thus, my former optimism that two national airlines might survive in the Canadian market has been tempered, though not extinguished, by recent events in Australia and Canada.

*In 2001, airports in Calgary, Winnipeg, Halifax and Ottawa had net profit margins in excess of 30 percent.*

The new Foreign Ownership Guidelines did lead to the entry of Virgin Blue. But the willingness of the Queensland Government to offer concessions and financial assistance might have been even more important in attracting Richard Branson to Australia. The entry of a foreign-owned carrier has effectively blocked entry by other domestic airlines.

It is also important to note that successful discount operators in other countries have generally avoided head-to-head competition with the hub-and-spoke networks of the incumbents by operating around the hubs and opening up new markets. In Australia, on the other hand, both the geographic distribution and density of the population, particularly on the eastern seaboard with more than 65 percent of the population, do not support hub-and-spoke networks. Rather, a point-to-point route network is more common in Australia. A point-to-point network does not provide start-up airlines the ability to create new markets; rather, they must go head-to-head in competition with the incumbents. Hence price, not service, is the only mechanism they had available to differentiate. The Canadian domestic market is more similar to the Australian market than to the U.S. market, although the Australian market does not have any counterpart to the trans-border routes to the United States.

Moreover, successful low-fare airlines in the United States, the United Kingdom and the European Union often operate from a major city's secondary airport — arguably an important source for cost savings and a competitive advantage. The use of a secondary airport allows the airline quicker aircraft turnaround, reduced terminal and landing costs and less congestion. In Australia there are few such opportunities available and both Impulse and Virgin Blue elected to utilize the same airports as the incumbents. In Canada, Hamilton Airport does provide a lower- cost, less-congested alternative to Pearson Airport and Westjet has taken advantage of this airport.

## Canadian Airports

In fiscal year 1996, the federal government implemented a National Airports Policy (NAP).[36] This policy shifted the government's role from owner and operator to landlord and regulator. The federal government retained ownership of the 26 airports identified as part of the National Airports System (NAS). However, under the NAP they were leased to the CAAs. The local operators are responsible for financial and operational management. According to the federal government, locally owned and operated airports would be able to function in a more commercial and cost-efficient manner, be more responsive to local needs and better able to match levels of service to local demands.

The NAP authorized the CAAs to introduce new user fees (AIFs) for specific capital projects at the larger airports as well as for capital and operating requirements at regional and local airports. As a result, the NAP was intended to shift the cost of running Canada's airports from taxpayers to those who actually use the facilities.

The CAAs are not-for-profit corporations headed by boards of directors. Those directors are nominated by different levels of government and other participating organizations, such as boards of trade and labour organizations. The federal government may appoint up to three directors.[37] According to the NAP, community accountability would be ensured through the enhanced principles of accountability under which CAAs would operate. These principles would be reflected in the Articles of Incorporation and bylaws of the CAAs and, where applicable, in the airport transfer legal documentation.

The combined net profits of the eight largest CAAs were $140 million in 2001. Their combined operating cash flows were $311 million. Their net profits equalled 11 percent of their total revenues in 2001. By comparison, Westjet, one of the most profitable airlines in the world, had a net profit margin of only 8 percent of total revenues.

In 2001, the net profit margins of these CAAs ranged from -7 percent for Edmonton to 38 percent for Halifax. In 2000, the margins ranged from 4 percent for Montreal to 40 percent for Ottawa. In 2001, four airports — Calgary, Halifax, Ottawa and Winnipeg — had net profit margins in excess of 30 percent. The eight major airports had accumulated a total surplus in excess of $1 billion by 2001. Considering that four airports were divested in fiscal 1995 — Calgary, Edmonton, Montreal and Vancouver — another three in fiscal 1997 — Ottawa, Toronto-Pearson and Winnipeg — and Halifax in fiscal 2000, these airports have built up a substantial surplus within a short period of time. The combined surplus of the eight airports increased 15 percent and 22 percent in 2001 and 2000 respectively, or by $308 million since 1999.

Unfortunately, under the National Airports Policy, the CAAs were not made accountable to two of their stakeholders — the airlines and their customers — and, as a result, the airlines, and indirectly their customers, have been placed at a

36 Prior to the announcement of the NAP, five NAS airports had been transferred to Local Airport Authorities — Vancouver, Calgary, Edmonton, Dorval and Mirabel.

37 Directors cannot be elected politicians or government employees.

bargaining disadvantage with the airport authorities. There is no effective mechanism in place to ensure that the decisions of the airport authorities will produce efficient results.

In 2001, the federal government announced its intention to develop a *Canada Airports Act*. The proposed legislation would clarify the roles and responsibilities of airport authorities. It also would focus on several other issues, including accountability to the public and users, improved governance, principles for setting fees and oversight of ancillary activities. Thus, the government has opened up an opportunity to correct defects in its original NAP.

But the entire blame for increasing costs should not be placed on the airports. The transfer of the airports to the airport authorities was accompanied by an obligation to pay the federal government annual and escalating rents. The federal government received $249 million in fiscal 2002 and these payments are expected to soon top $300 million per year. The ground-lease payments made by the eight largest CAAs to the federal government represented 22 percent of their total expenses — a significant proportion of the total costs of these CAAs.

These rents are an indirect form of taxation on the industry and the federal government has taken out over $650 million more from the airline industry than it has put back in over the past four years. This does not include the $1.5 billion taken out by the government when Nav Canada was created in 1996 and paid this amount to the government for the assets this new company acquired.

*There would appear to be limited scope for foreign airlines or foreign investors to create and operate a domestic Canadian airline.*

The federal government is currently also in a rent review process. According to the government, this review will ensure that the government's airport rent policy balances the interests of all stakeholders, including the air industry and Canadian taxpayers. So there is an opportunity for some re-balancing in this area as well.

## Conclusions

As noted, the primary objective of this report is to assess the competitive effects of the Review Panel's recommendations for the passenger aviation services market in Canada.

### *Scope for New Entry*

We begin by considering the scope for new entry into the Canadian domestic market.

Foreign entry could occur in the following forms:

- Adding an extra Canadian leg to spokes currently terminating in a Canadian city (consecutive cabotage).
- Creating a domestic Canadian carrier (the Virgin Blue strategy). A domestic Canadian carrier could be structured as a shuttle service in short-haul, high-density markets (the Impulse, U.S. Airways Shuttle models); a hub-and-spoke network, with a hub in Toronto (JetBlue, AirTran models) or perhaps in Calgary, Winnipeg or Montreal; or as a point-to-point service (Westjet, Southwest models).

- Serving Canadian cities through existing U.S. hubs (modified sixth freedom), such as Minneapolis (Northwest), Chicago (American), Detroit (Northwest), Cleveland (Continental), or Cincinnati (Delta).

U.S. airlines are the most likely to consider entry into the Canadian market if they are granted modified sixth-freedom rights, or some form of cabotage rights. Non-U.S. airlines do not operate U.S.-based hubs that could be used with modified sixth-freedom rights. As for utilizing consecutive cabotage rights to serve the domestic Canadian market, non-U.S. airlines cannot offer the frequencies required to attract the business traveler and there is a greater likelihood of delays with overseas flights, further diminishing the attractiveness for the business traveler. But the Qantas experience in Australia under the country's Two Airline Policy indicates that non-U.S. carriers could offer very cheap fares for the leisure traveler in Canada, who is much less concerned with frequencies and punctuality. Although there would appear to be some scope for entry into the Canadian market by foreign airlines, the size and structure of the Canadian market might limit the potential for entry. There might be a few city-pairs in Canada that could prove to be attractive to foreign airlines. But there might be too few markets that could support more than one or two competitors.

*Some foreign entry is likely to take place, assuming new bilateral agreements can be reached.*

Adding an extra Canadian leg to spokes currently terminating in a Canadian city (consecutive cabotage), and serving two Canadian cities through a U.S. hub would appear to be the more likely avenues for expansion into the Canadian market, especially by U.S. airlines. But flight frequencies are very important for time-sensitive travelers. Serving the Canadian market using modified sixth-freedom rights might not provide a sufficient incentive for a U.S. airline to offer a large enough number of daily frequencies between Canadian cities to attract the business traveler. The inability to attract the business traveler would reduce the attractiveness of offering the service between two Canadian cities via a U.S. hub and would further decrease the likelihood of attracting these customers. Of course, the economics of regional jets might enable U.S. airlines to take advantage of modified sixth-freedom rights by having their regional partners provide the necessary number of daily flights on select routes. But the more limited range of these jets limits their use on the trans-continental markets in Canada.

If U.S. carriers were to start serving the Canadian market, other than by setting up a domestic Canadian subsidiary, the most likely markets to attract their attention would be the eastern and western triangles and the trans-continental Toronto-Calgary and Toronto-Vancouver markets. The eastern triangle and trans-continental markets are the key domestic profit generators for Air Canada and Air Canada would not stand by and allow its market shares to wither. The western triangle would be strongly defended by Westjet.

The experiences of Westjet in Canada and Southwest in the United States demonstrate that traffic can be stimulated, even in what appear to be thin markets, by low fares, reliable service and a reasonable number of daily frequencies. Therefore, there might be more opportunities beyond the obvious eastern and western triangles and the trans-continental routes to Toronto. But the number of entry points is still likely to be quite limited. The Australian experience to date reinforces this view.

There also would appear to be limited scope for a foreign airline or foreign investors to create and operate a domestic Canadian airline. The financial difficulties facing the industry worldwide make this option even less likely at this time.

The geography and population distribution of the Canadian market greatly limit the potential for hub-and-spoke networks. So too does the importance of Toronto Pearson Airport and the limited potential to create a second hub operation at this airport. Consequently, in Canada, a point-to-point network does not give a start-up airline the same latitude to create new markets by overflying hubs, as has been the case in the United States.

## *Likelihood of New Entry*

What is the likelihood that new entry might, in fact, occur if the Canadian market is opened to foreign airlines and investors along the lines recommended by the Review Panel? Who might enter and in what markets?

Let us start by considering the consecutive-cabotage option. Foreign carriers, other than U.S. carriers, might take advantage of this right if it would enable them to increase the daily utilization of their aircraft at relati..ly low cost or improve their competitive position in attracting business travelers on the trans-oceanic routes. But there would be few city-pair markets that would likely be served and the service would cater to leisure travelers within Canada.

*The cumulative effects of AIFs and the Security Tax in Canada exceed those in the U.S. by significant amounts.*

U.S. carriers are unlikely to take advantage of this right w'hin the Canadian market because their focus is on building up their hubs and in the process, they are minimizing the number of multi-stop spokes in order to reduce the cascading effect throughout their entire networks of delays at their hubs. U.S. carriers would more likely consider the feasibility of adding a new non-stop spoke or additional frequencies on existing non-stop spokes to Canadian cities than adding another leg to an existing spoke to a Canadian city. They are able to do this at the present time under the Open Skies Treaty with Canada.

Under the existing Treaty with the United States, Southwest, AirTran and JetBlue can operate any trans-border route they desire. The fact that they have not yet announced plans to fly to a Canadian destination suggests that they are more comfortable pursuing opportunities in their domestic market.

The modified sixth-freedom right would more likely appeal to U.S. carriers than the consecutive cabotage right. But as noted above, this right would have no attraction for non-U.S. airlines. U.S. airlines that already operate to more than one Canadian city from their hubs could quite easily offer a through fare connecting some Canadian cities. This possibility exists for U.S. airlines with hubs near the Canadian border; otherwise, the inconvenience of longer flights might offset the benefits of lower fares for the time-sensitive traveler.[38] Leisure travelers on the other hand, might be attracted by low fares and more time consuming connections through any U.S. hub.

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38 The time factor makes flights between cities in Western Canada or between cities in Eastern Canada through a U.S. hub unattractive for the business traveler.

The option to start and own a domestic Canadian carrier is unlikely to appeal to most foreign airlines and is unlikely to lead to any significant entry. The Virgin Group has demonstrated its willingness to start up airlines in other countries — Virgin Express, with its base in Brussels, and Virgin Blue. The track record of the Virgin Group to date does not provide much confidence that it would enter the domestic Canadian market, or if it did, that it would be a long-term force in this market. Richard Branson has sold significant stakes in Virgin Atlantic, Virgin Express and Virgin Blue. Moreover, neither Virgin Atlantic nor Virgin Express is consistently profitable. Indeed, recently their financial performances have been marginal at best.

Singapore also has acquired controlling stakes in other airlines. But Singapore is part of the Star Alliance and so has a strong link in Canada through Air Canada.

Overall, in light of the latest round of consolidation in the United States, the existence of four distinct global alliances involving the major U.S. airlines[39] and the economic environment for the industry, the number of airlines that might potentially take advantage of greater access to the Canadian market, whether as the outcome of unilateral decisions by the Canadian Government or bilateral or multilateral negotiations, likely would be quite small. Only the Oneworld Alliance had a presence in the Canadian market prior to Air Canada's takeover of Canadian Airlines. American Airlines has a code-sharing arrangement with Air Canada on former Canadian Airlines-operated routes. Therefore, it would appear that the Oneworld group would have the strongest incentive to re-enter the Canadian market. But at this time, British Airways and American Airlines, the two lead players in the Oneworld Alliance, are faced with much more important issues, including surviving the fallout of the global recession and a renewed attempt at forging a closer relationship.

The other two major alliances[40] would less likely be concerned about a limited presence in the Canadian market for two important reasons. Neither has had a strong presence in Canada in the past and the relatively small feed potential from Canada makes direct entry into the Canadian market a low priority, especially with a weak economy and a new round of restructuring of the airline industry worldwide.

The likelihood of new entry is further diminished by the impacts of the AIFs and the federal government Airport Security Tax.[41]

To examine the effects of the AIFs and the security tax, on October 30, 2002, I randomly selected flights with departure dates on either November 12 or 13 and return dates between November 15 and 19 and recorded the lowest fares on these flights. I picked Air Canada mainline, Tango and Zip, Westjet and Jetsgo in Canada, and Southwest and JetBlue in the United States.

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39 The number of alliances might drop to three as a result of the new code-sharing agreement among Delta, Continental and Northwest.

40 The other two alliances are Wings (Northwest, Continental, KLM and others) and the Air France-Delta alliance, which includes several other carriers.

41 Canada had the highest Security Tax ($22.43 exclusive of GST/HST) among all the major countries according to IATA data prior to the most recent budget. Even after being reduced to just under $12, the tax compares to a tax of $7.50 (Canadian dollars) for the United States.

The cumulative effects of the AIFs and the Security Tax in Canada exceed those in the U.S. The gap widens as the base fare declines. Business travelers and leisure travelers in Canada face a much higher tax burden than do U.S. travelers. In Canada, the cumulative effects tend to average 7 percent for base fares in the $500-to-$600 range; 10 percent for fares in the $400 range; 14 percent for fares in the $200-to-$300 range; 23 percent for fares between $100 and $200, and in excess of 40 percent for base fares below $100. In the United States, the cumulative effects are generally less than 10 percent, regardless of the fare. Consequently, Canadian travelers are disproportionately disadvantaged on short-haul flights and discount flights compared to U.S. travelers and this greater tax burden on ticket prices is unlikely to make entry into the Canadian market attractive for any foreign airline.

### *Impact of New Entry*

If new entry by foreign airlines did occur, how might this affect the plans for further entry by Canadian companies and what might be the net effect on competition in Canada? As discussed, the scope for entry by foreign airlines is limited, as is the likelihood that entry might occur. So the potential impact might appear to be rather limited, as well. But some entry is likely to take place, assuming that new bilateral agreements can be negotiated along the lines proposed by the Review Panel, and because of the size of the Canadian market and the fragility of the industry, particularly at this time, even a limited degree of entry could have a significant impact on the Canadian airline industry.

The U.S. airline industry has a graveyard filled with large numbers of unsuccessful entrants. There have been a number of failures of entrants in Canada and in Australia, as well. Thus, we should not expect a free-for-all of entry if new agreements are negotiated by the federal government to encourage entry into the Canadian market. The Canadian market, with the exception of a very small number of city-pairs, is relatively small. During the past three years, entry occurred in only a handful of city-pairs in Canada. As a result, whatever entry might take place would likely come at the expense of further expansion by the Canadian incumbents and probably would risk the future viability of one or both of these companies, unless the only change is a relaxation in the foreign ownership limits. The airline industry is relatively cyclical. Because the industry has high fixed costs in relation to revenues, a small change in load factors or fare levels has a large impact on profits.

A relaxation of the foreign-ownership limits might do more to ensure the survival of domestic competition than any other policy changes. This could increase the sources of capital available to Canadian carriers and, for the well-managed ones, access to more sources of capital should also reduce the costs of capital.

If the federal government does succeed in negotiating a more liberal agreement with the United States, then I would expect the following:

- There would be limited entry at best — there are a very small number of markets in Canada that provide entry opportunities — and the entry might end

up displacing Canadian companies, in terms of the routes they operate and the number of frequencies they provide on existing routes.

- Even limited entry would weaken the financial performance of Westjet, but might actually benefit Air Canada because it could use modified sixth-freedom rights to capture the benefits of its Toronto hub within a North American market.

While I fully support the recommendations of the Review Panel, I believe that the competitive consequences for the domestic Canadian market of a bilateral agreement with the United States are likely to be minimal. Perhaps it is time to recognize that the characteristics of the Canadian market limit the scope for competition and the number of domestic incumbents, regardless of the regulatory environment.

## Epilogue

There have been many other proposals put forth to increase competition in the Canadian market. One group of proposals focuses on stimulating entry by new Canadian carriers. Another group looks at increasing foreign competition in Canada. The only two proposals that merit some consideration are re-regulation and unilateral actions by Canada to open up the domestic market to foreign airlines and investors.

In terms of unilateral actions, I have argued, opening the Canadian market to foreign airlines is likely to result in limited new entry at best. However, would Canadian consumers not benefit sooner if the federal government opens up the domestic market without waiting to negotiate bilateral or multilateral agreements? Is it not better to have some competition sooner than later, especially since there is no assurance that any agreement could be negotiated?

Yes, there would be some benefits for Canadians traveling across the country, but the benefits in the form of lower fares and more choice would be small and might not be permanent. Unilateral actions likely would eliminate the possibility of new entry by a Canadian company by increasing the risks that such a company would face and thus deter investors from backing any such venture. In addition, even some modest degree of entry by foreign airlines would increase the risks facing Air Canada and Westjet and might jeopardize the survival of one or both companies. But should it matter to Canadian consumers and Canadians in general whether any Canadian airline survives to provide domestic service?

My unequivocal answer is yes it does matter!

Unilateral actions could produce modest benefits for consumers but would increase the risks for survival of Canadian carriers. These risks are not worth the benefits. In my opinion, because the consequences of unilateral actions cannot be predicted with any degree of certainty, I would rather err on the side of caution and not run the risk that such actions might lead to the takeover of either or both Canadian airlines by foreign airlines. Further, there is no reason to give up important bargaining chips because there is more at stake than possible consumer benefits.

With regard to the re-regulation proposals put out by Transport Minister Collenette, they would not lead to increased competition. At best, they might increase the number of competitors, but at the expense of stifling competition and innovation. Under the proposed regulatory regime, a new entrant, regardless of how well managed, how efficiently it might be operated and how good a business model it might have, would not survive in the domestic market. In addition, the externalities of Air Canada's network might diminish with the size of the network as Air Canada would be forced to retrench. The consequences would be more likely to produce negative economic effects than competition and consumer benefits.

The minister's latest proposal to require all airlines to facilitate interlining with other Canadian carriers runs counter to the Westjet model, which avoids interlining. Indeed, if the government were to implement this policy, it would most disadvantage Westjet since it would disrupt the company's operating model.

If the government is concerned that a new and lower-cost Air Canada might exploit its new monopoly powers, when it exits bankruptcy protection, by raising fares in many domestic markets and might abuse its dominant position by engaging in predatory behaviour against a new entrant or Westjet, there are simpler solutions than re-regulation. For example, the Competition Bureau could be given the responsibility to review annually yields in the domestic market and to order roll-backs in fares and yields if the annual increase exceeded some target level — the rate of inflation less X percent, or the rate of increase in average yields in the U.S. market. As well, simple rules could be put into place that would make it easier for the Competition Bureau to conclude that Air Canada has abused its position of dominance. For example, the *Competition Act* could be amended so that if Air Canada implemented any of the following strategies in response to entry:

- Increase frequencies on routes where an entrant has announced an intention to start operating or has started serving within the past six months;
- Match the prices (for full fares) offered on such routes;
- Increase the availability of seats at deep discounts on such routes;

the company should not be allowed to reverse the strategy (strategies) for at least 12 months unless it could demonstrate that unforeseen changes occurred in the marketplace. If Air Canada were to reverse itself without a suitable explanation, the company could be found guilty of abuse of dominance without the need for any further investigation, and be subject to fines and a civil suit by the entrant damaged by such actions.

There are problems with this approach. But it would seem to be less invasive of private decision-making and real competition in the domestic market.

While I may not have been a supporter of deregulation in 1984, I do not favour a return to regulation at this, or any other, time. The decision was made to unleash market forces and I believe that we should live with the consequences, even if they are not what were originally anticipated. Nor do I support government bailouts of any company in this industry.

There is little realistically that the federal government can do to create widespread competition in the domestic market; nevertheless, the federal government does have some options to establish a more competitive environment.

In conclusion, I would strongly endorse the following:

- The foreign ownership limits should be increased to 49 percent immediately and then to 100 percent when either the bilateral agreements will accommodate this or the global airline industry has become deregulated.
- The limit of 15 percent ownership of Air Canada by any individual or group of related individuals should be eliminated.
- The federal government should immediately offer all of its bilateral partners the option to convert the existing agreements into open skies accords with no restrictions on each nation's carriers. That is, airlines in each country should be granted modified sixth-freedom rights, consecutive cabotage rights and stand-alone cabotage rights.
- The federal government should take the lead in calling for an international conference to discuss and negotiate a multilateral free trade agreement for the airline industry. The conference could take place under the joint auspices of the WTO and the ICAO.

As well, the airport authorities and Nav Canada should be subjected to price regulation by the Canadian Transportation Agency.

Finally, the federal government should reduce its annual lease payments from the CAAs and make sure that the cost reductions for the airports are passed on entirely to the airlines and their passengers. As well, in order to assist the industry in coping with the multiple shocks that have made an impact on it during the past three years, Ottawa should eliminate its airport-security tax altogether. Overall, the time to make air travel less expensive and more flexible for Canadians is now, though Ottawa must choose its policies with great care or government actions will make this form of transportation less appealing in the long term. A minimalist approach by Ottawa, including staying away entirely from the bankruptcy-protection process for Air Canada, would be the most prudent course for the government to follow.

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